



Written Testimony to the
Commodities Futures Trading Commission
Washington, DC

January 31, 2013

By

Will Rhode

Director, Fixed Income Research

TABB Group

Swap futures act as a wrapper to insulate swaps users from some of the more punitive elements of Dodd-Frank reform. On one hand, they may be viewed as a healthy, innovative response by the financial services industry to regulatory change. Given that Congress looked to the futures market as a guide for swaps reform, it could be argued that swap futures are consistent with regulatory intent. In many ways, they appear to be a logical progression. On the other hand, swap futures can be viewed as regulatory avoidance. To borrow from Myron Scholes: “One of the reasons we have financial innovation is to get around rules and regulations.”¹ Swap futures obviate six specific elements of the reform process:

- Dealer registration
- Margin treatment
- Block thresholds
- Clearing competition
- Execution competition
- Open Reporting

Thus, swap futures appear to destabilize three pillars of the 2009 G20 commitment to reform the swaps market. First, by removing the need for heavy users of swaps to register as dealers and lowering block thresholds so that bilateral off-exchange trading may be facilitated swap futures appear to undermine the G20’s transparency goals. Second, the amount of posted margin for futures is lower than for swaps; this creates concerns that swap futures will lead to more, not less, systemic risk. And third, the vertical nature of futures clearing and licensing rights appear contrary to the open choice clearing and execution structure designated by the Commission in the Dodd-Frank rulemaking process.

To shed light on the issues and the challenges regarding consistency between swaps and futures regulations, we would like to present an analysis of three swap future initiatives. We hope this will help guide on any changes that should be addressed regarding consistency between swaps and futures regulations.

ICE Energy Futures

On October 13-14, 2012, IntercontinentalExchange (ICE) transitioned existing open interest in cleared over-the-counter (OTC) swaps and options (cash-settled) positions to futures. The transition was quick and seamless, demonstrating that while energy swaps have traded alongside energy futures on the ICE trading platform for more than a decade, there was, in reality, very little to separate the two instruments. With active clearing comes a demonstration of standardization that moves swaps closer to futures. TABB Group believes the same will be true for certain swaps of other asset classes as

¹ March 2012, Stanford Institute for Economic Policy Research

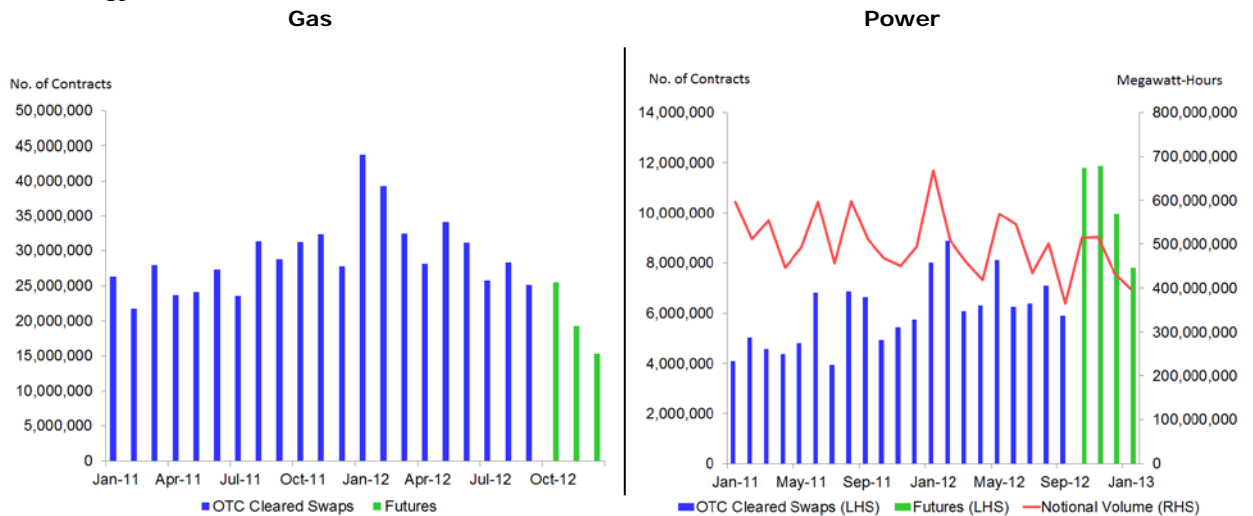
they make the migration into central clearing and become more actively cleared over time.

The decision to transition energy swaps to futures was triggered by two drivers: a desire for regulatory certainty, as the Dodd-Frank rulemaking process extended longer than anticipated; and a desire to help swaps users reduce the burden of the Dodd-Frank registration mandate, which is viewed as onerous. ICE customers both understood the futures market better than the evolving swaps framework and were already registered to trade swaps.

To date there has been little material impact resulting from the transition. Trading volumes at the ICE have retained the same trajectory. Gas volumes continued a seasonal downturn that started before the transition and, while the Power market experienced an increase in contract volume as less liquid, “mini” contracts started to clear as futures, notionally speaking, volumes remained consistent (Exhibits 1 & 2).

Exhibits 1 and 2

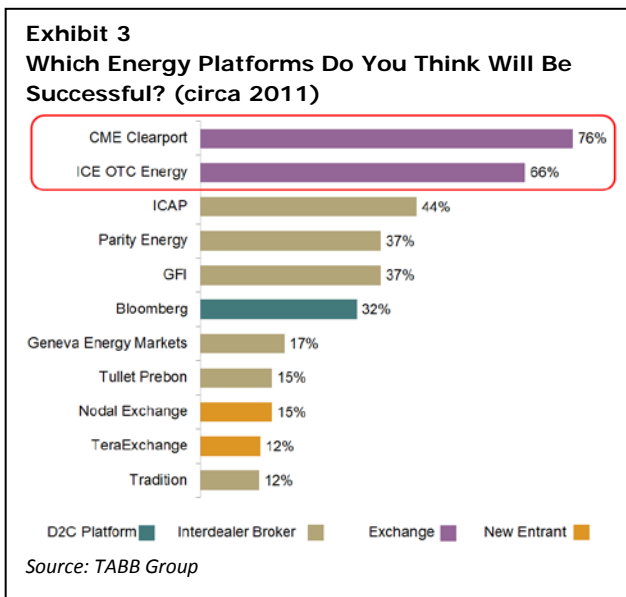
ICE Energy Contract Volumes



Source: TABB Group, ICE

It is hard to conclude that there has been any material impact on the energy swaps markets as a result of the migration to futures. Swaps users have not increased their use of futures, competing exchange volumes have not been cannibalized, and systemic risk concerns do not seem to have been elevated. Positions are trade reported in a manner that is consistent with futures reporting regimes. It could even be argued that the ICE Energy swaps transition to futures is consistent with regulatory ambitions to minimize the impact of swaps market reform on end users who might have been caught up in the dealer registration process as an unintended consequence.

While there is little change in the trajectory of the ICE market, however, the migration will make it harder for other energy marketplaces to compete as result of vertical efficiencies. TABB Group believes the advent of swap futures will further entrench an already-established dominant position held by ICE and CME’s Clearport in the energy market (Exhibit 3)².



CME Group Deliverable Swap Futures & Eris Swap Futures

In October 2011, Eris Exchange announced its IMM-dated swap futures contracts, and in December 2012, the Chicago Mercantile Exchange (CME Group) launched Deliverable Swap Futures (DSFs). Marketing efforts around both products have focused less on the registration process and more on their ability to mimic the economic benefits and cash flows of an OTC interest rate swap and their ability to deliver margin efficiencies, as well as the lower block treatment that will be applied to the instruments.

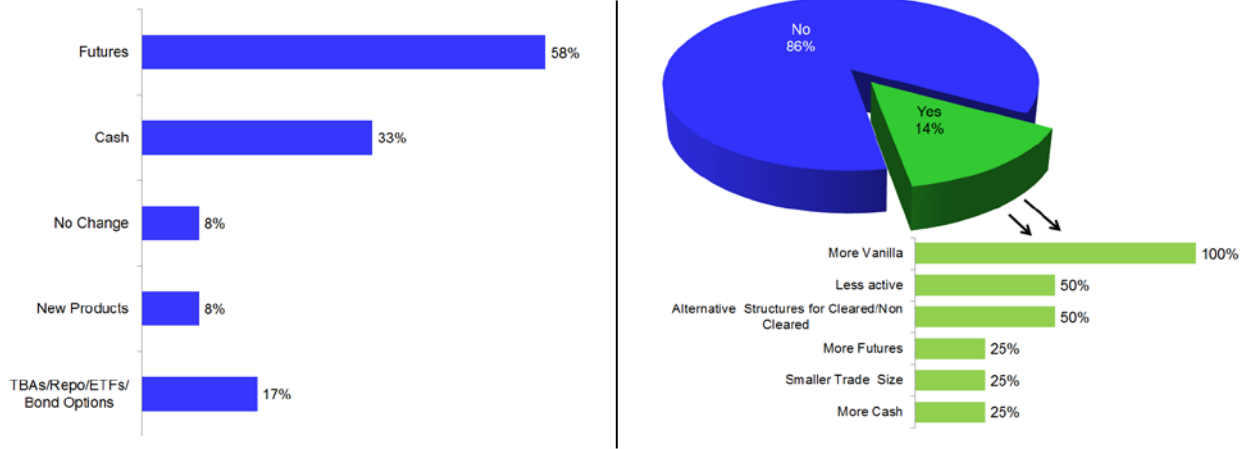
Over the past year, TABB Group has conducted more than a hundred interviews with swaps users. The bulk of the conversations have centered on the new, frictional costs associated with swaps trading as a result of Dodd-Frank reform, particularly in terms of clearing. What was previously a very cheap and flexible financial market instrument is becoming a more expensive, rigid one. Buy-side firms have expressed a willingness to migrate to futures in the event that swaps become prohibitively expensive (Exhibit 4)³. That said, the majority of market participants have yet to seriously consider changing their trading strategies as a result of the new rules (Exhibit 5). We believe that the market will only be able to measure the true extent of the buy side’s willingness to migrate once the buy-side clearing mandate goes live in June.

² “SEF Industry Barometer,” TABB Group, November 2011

³ “US Buy-Side Swaps Trading 2012: I Can See Clearing Now,” Will Rhode, TABB Group, June 2012

Exhibits 4 and 5

Assuming Margin Makes Swaps More Expensive, What Other Products Will You Use? / Have You Changed Your Trading Strategy in Response to Expected New Rules?



Source: TABB Group

It may also be that the buy side is yet to fully appreciate the change in cost structure. A comparative analysis between an OTC swap trade and a similar Eurodollar (ED) strip trade illustrates the point: Over the life of a typical trade, swaps' higher initial margin levels make them significantly more expensive to trade than futures (Exhibit 6)⁴. This is true even though the tangible (or explicit plus implicit) costs of the OTC swap (\$12,779) are nearly 20% less than the same costs for the ED strip (\$15,200). The cost of margin accounts for the difference between these two figures. While cleared swaps are subject to a 1.5% initial margin charge, the ED margin rate is just 0.014%.

⁴ "The New Global Risk Transfer Market: Transformation and the Status Quo," Paul Rowady, TABB Group, September 2012

Exhibit 6

Swaps vs. Futures – A Cost Comparison

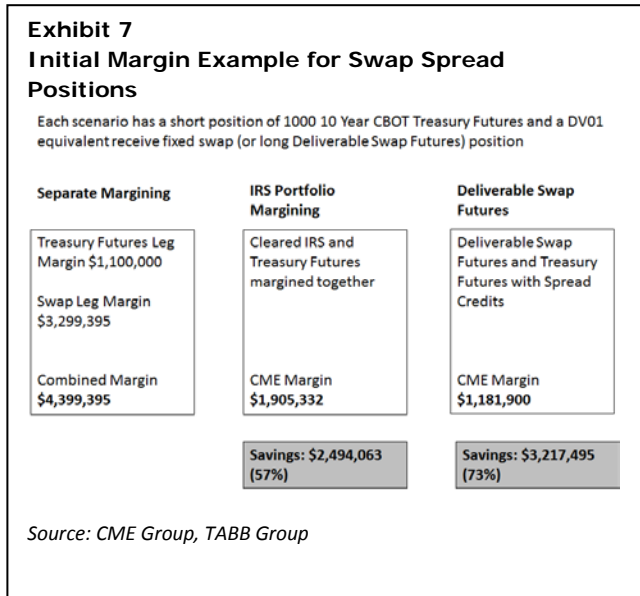
Exposure Characteristics		Units
Duration	5	years
Notional	\$100,000,000	
OTC Vanilla Swap - D2C		
Bid Ask Spread	0.4	bps
Value of B/A spread	\$10,000	
Total Cost	\$10,000	
OTC Vanilla Swap - CME Cleared		
Clearing Fee	\$4.50	per million
Execution Fee (SEF)	\$4.50	per million
FCM Clearing Fee	\$4.50	per million
FCM Exec. Fee	\$4.50	per million
Transaction Fees	\$1,800	
Maintenance Fee	\$200.00	per year
NPV of Maintenance Fee	\$979	
Total Explicit Costs	\$2,779	
Total Explicit and Implicit Costs	\$12,779	
Current Estimated Margin Rate	1.50%	
Minimum Opportunity Cost of Margin (NPV)	\$72,801	per year (RFR 1%)
Total Explicit, Implicit and Opportunity Costs	\$85,580	
Eurodollar Strip - Customer via FCM		
Number of Contracts	2,000	
Clearing Fee	\$0.13	per contract
Execution Fee	\$0.55	per contract
FCM Clearing Fee	\$0.13	per contract
FCM Exec. Fee	\$0.55	per contract
Transaction Fees	\$2,720	
Bid Ask Spread	0.00125	bps
Value of B/A Spread	\$12,500	
Total Explicit and Implicit Costs	\$15,220	
Current Estimated Margin Rate	0.014%	
Minimum Opportunity Cost of Margin (NPV)	\$1,359	per year, (RFR 1%)
Total Explicit, Implicit and Opportunity Costs	\$16,579	

NOTES: 1 - ISDA, 2 - CME, 3 - SME, TABB Group estimate

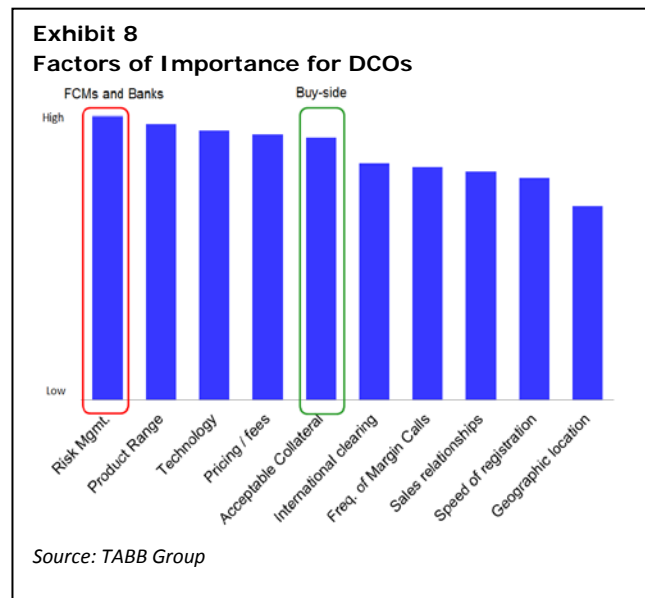
OTC Swap	CME Cleared OTC Swap	Eurodollar Future
\$10,000	\$85,580	\$16,579

Source: Devonshire Investors, TABB Group

This is the result of differences in risk calculation methodologies. While swaps are subject to a 5-day Value-at-Risk (VaR) charge, futures only incur a 1-day VaR charge. The reason for the discrepancy may be historical – while the futures market has marked-to-market on a daily basis, the swaps market has its roots in OTC bilateral trading, which valued positions less frequently and incorporated a more conservative risk calculation. Nevertheless, an obvious contradiction exists: Given that lower costs push participants toward the swap future, the market could see a 73% reduction in deposited margin at the Derivatives Clearing Organization (DCO) (Exhibit 7). Given a market shock, the reduced margin balances may influence the financial soundness of the clearing infrastructure.



The marketplace shares the concern. As part of a private consulting project that TABB Group conducted in May 2012, for which we spoke to 50 buy- and sell-side firms, risk management ranked highest in terms of factors of importance in their selection of DCO, particularly among banks and Futures Commission Merchants (FCMs); acceptable collateral and the ability to reduce the cost of clearing ranked fifth, due largely to the influence of buy-side firms (Exhibit 8).



TABB Group understands that the buy side is struggling to comprehend and digest the cost of clearing. Both the Eris and CME Group contracts will clear through the CME Group; therefore users will be able to achieve margin offsets with treasury futures and cleared IR swaps. But while DCO efforts to reduce costs and realize efficiencies through portfolio margining are to be applauded, these innovations should not come at the expense of safety. For this reason, TABB Group believes harmonization in margin treatment between OTC interest rate swaps and their equivalent swap futures needs to occur, either via an explicit directive from the Commission, or as part of a market-led initiative, in order to preserve the sound functioning of financial markets.

Block Treatment and Transparency

Both Eris swap futures and the CME Group’s DSF will be subject to lower block thresholds, compared to the Commission’s proposed rules for equivalent interest rate swaps. In the case of DSFs, the block threshold is between 24% and 40% that of the Commission’s proposed size for equivalent contracts, while the Eris future is just 7% to 11% (Exhibit 9).

It should also be noted that swaps transactions will be required to report in real time, while there is a 10-minute delay in futures price reporting.

Lower block thresholds for swap futures will facilitate off-exchange, bilateral trading and will counter the Commission’s efforts to increase transparency in the swaps market by setting block thresholds designed to drive trading on new, multilateral Swap Execution Facilities (SEFs). TABB Group believes that block treatment for swap futures and swaps will need to be harmonized if the Commission’s ambitions to improve transparency through on-exchange trading are to be preserved.

Exhibit 9
Block Sizes for US Dollar Interest Rate Hedging Products (MM)

	2 Year	5 Year	10 Year	30 Year
CME Deliverable Swap Futures	\$300	\$150	\$100	\$50
CME Treasury Futures	\$1000	\$500	\$500	\$200
CME Interest Rate Swap Futures	N/A	\$200	\$200	\$200
Eris Swap Futures	\$50	\$25	\$25	\$25
CFTC Proposed Threshold for Swaps	\$750	\$380	\$290	\$210

Source: TABB Group, CFTC, Exchanges

It appears that the CME Group agrees. In its comment letter on “Swap Data Recordkeeping Reporting of Swap Transaction Data,” it wrote:

“CME Group believes that final rules governing blocks of swaps that involve instruments where there is an economically equivalent futures contract listed on a DCM should be comparable to the rules that govern block trades for such futures contracts, including but not limited to, size requirements, any restrictions placed on the percentage of blocks that may be done relative to the overall size of the relevant market, and reporting and recordkeeping requirements. Disparate rules for economically equivalent instruments will have the unintended consequence of tilting the playing field in favor of one class of instruments, which is not the intent of the DFA.”⁵

The Commission should also closely consider the CME Group’s view expressed in its comment letter on “Procedures to Establish Appropriate Minimum Block Sizes for Large Notional Off-Facility Swaps and Block Trades”:

⁵ CME Group Comment Letter on “Swap Data Recordkeeping Reporting of Swap Transaction Data”, February 11, 2007, Craig S Donohue, Former CEO

“From a practical implementation standpoint, the Commission would be better served by retaining the ability to set block levels in the private, bilateral swaps market and deferring to the expertise of SEFs and DCMs to set the levels in their own markets.”⁶

TABB Group also believes the Commission has it right when it proposes in its “Procedures to Establish Appropriate Minimum Block Sizes for Large Notional Off-Facility Swaps and Block Trades” that:

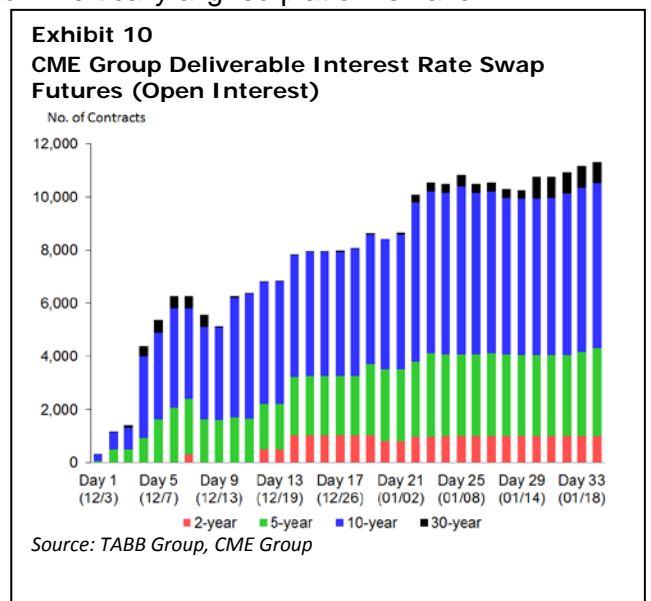
“Swap contracts and futures contracts that are economically related to one another—as defined by the Commission in a proposed amendment to § 43.2—are economic substitutes that should be subject to the same appropriate minimum block sizes or block trade rules for futures contracts, as applicable.”⁷

Clearing and Execution Choice

There are concerns that a lack of futures fungibility will inhibit clearing competition and licensing rights will prevent competition in execution. Vertically aligned platforms have the power to adjust costs to lock in trading, clearing, and/or reporting, making it harder for other trading venues and clearinghouses to compete. They also retain the ability to alter those cost structures in the future. While swaps prices are to be reported to public Swap Data Repositories (SDRs), futures exchanges own the prices they report and will be able to charge for their release.

Exchanges globally have successfully argued that there are risks associated with a futures product launch and, since the exchange has taken that risk, it deserves to own the product both from a licensing and clearing perspective. Indeed, swap futures have failed in the past.

The International Derivatives Clearing Group (IDCG) launched a swap future in December 2008 only to see it become subject to a lawsuit. Meanwhile, DSF volumes remain modest and there is no guarantee the product will succeed. Even if the industry



⁶ CME Group Comment Letter on “Procedures To Establish Appropriate Minimum Block Sizes for Large Notional Off-Facility Swaps and Block Trades,” May 14, 2012, Phupinder Gil, CEO

⁷ “Procedures To Establish Appropriate Minimum Block Sizes for Large Notional Off-Facility Swaps and Block Trades,” Section II.C.4 Federal Register / Vol. 77, No. 51 / Thursday, March 15, 2012 / Proposed Rules

embraces swap futures, we believe DSFs will still only account for 3% of the notional outstanding of the swaps and swap futures market by mid-year 2014 (Exhibit 10).

DCMs vs. SEFs

With regulation delays, exchanges have been able to get a head-start on their would-be SEF competitors through the launch of new swap futures. TABB Group expects this trend to continue. The buy side has expressed a desire for a delay in the SEF execution mandate until mid-2014 to give it time to digest the implications of clearing. Given the cost benefit of traditional swaps versus cleared swaps, or even swap futures, it should be suggested that the buy side has a vested interest in seeing delays in the execution mandate: The longer it takes for the rules to go live, the fewer SEFs will survive; fewer SEFs will reduce the burden of buy-side market fragmentation.

That said, we believe there still will be room for other market constructs. Institutional investors are unlikely to migrate to a Central Limit Order Book (CLOB) overnight and will want to execute trades on platforms that they are used to, such as Request-for-Quote (RFQ) SEFs, before migrating to other CLOB SEFs or exchanges. Meanwhile, many end users will be prepared to pay more in the bilateral market for bespoke swaps that fit their precise hedging requirements, both from a risk management as well as an accounting viewpoint. Undoubtedly, some firms may seek out next “best fits,” introducing an element of basis risk; but we see this as an enterprise issue, not a systemic one.

Futurization Benefits

Futurization opens up the swaps market to new trading participants and sources of market liquidity, such as high-frequency trading (HFT) firms. HFT firms have been known to significantly reduce bid/ask spreads and improve execution quality in the equity market. But there are question marks over the role such liquidity providers will play in the swap futures market. Institutional investors worry about the level of commitment HFT firms have to providing market liquidity, as well as their ability to time the “roll” as the futures contract expires and market participants are forced to roll into a new contract to maintain the hedge. This could expose institutional investors to the possibility that high-frequency traders will time the roll and cause the price of the contract to increase during this period. TABB Group therefore believes that the Commission should consider in remaining Dodd-Frank rulemakings the potential role that HFT firms could play in the swap futures market.

Innovation in financial services must be fostered even as the regulatory process unfurls. At some point, regulators need to finalize the rules in order to allow the seeds of new markets to germinate and grow. The question is whether some level of protection should be afforded to the new horizontal market structure that the Commission has designed so that it may emerge and flourish, or if the Commission will consider swap futures as a viable alternative to the traditional dominance of banks in the OTC swaps market. Both avenues open the swaps market to new competitive elements, which should be considered a success of the Dodd-Frank rule-writing process. The only question that

now remains is how best to balance the playing field between these new dynamics so that other tenets of the reform process are just as successfully observed and deployed.

Conclusion

While we have focused on three swap futures initiatives for the purpose of this analysis, they are by no means the only examples, nor will they be the last. ICE and the CME Group have announced plans to launch futures on non-deliverable forward (NDF) currencies, such as the Indian rupee. There is also a proposal by ICE to develop futures and options contracts based on Markit's North American and European corporate credit default swap (CDS) indices, the Markit CDX and Markit iTraxx index families. Given the high degree of standardization in these instruments and the potential for significant margin savings, this family of OTC swaps is ripe for a migration to futures.

The overwhelming message from the market is that swap futures are more efficient, cheaper to use, easier to deploy, and have less regulatory heartache than swaps. They also fulfill many of the major G20 requirements for the treatment of swaps. While we believe swap futures will be successful, we do not believe they will take over the swaps market. That said, we do observe some disharmony in the regulatory treatment of swap futures versus swaps that could advantage the former (Exhibit 11).

Exhibit 11
Regulatory Disharmony: Swap Futures vs. Swaps

	Registration	Margin	Blocks	Clearing	Flexibility	Execution	Reporting (SDRs)
Swaps	Yes	5-Day VaR	High Threshold	Horizontal	Custom	TBD	Free
Swap Futures	No	1-Day VaR	Low Threshold	Vertical	Standard	Open access	Fee-based

Source: TABB Group

Beyond these details, however, TABB Group believes there is really only one question the Commission has to consider when it comes to the future of swaps and the role of swap futures: Has the swaps market become over-regulated, or is the problem that the futures market is under-regulated? We believe the answer to this question will ultimately guide the Commission when considering changes to one of the remaining Dodd-Frank rulemakings or through modifications to already-implemented regulatory provisions.

